

REPORT/RECOMMENDATION TO THE BOARD OF SUPERVISORS  
OF SAN BERNARDINO COUNTY, CALIFORNIA  
AND RECORD OF ACTION

August 31, 1999

**FROM:**           **WILLIAM H. RANDOLPH**  
County Administrative Officer

**SUBJECT:**       **ADOPT RESOLUTION AUTHORIZING A CALLABLE FIXED-TO-FLOATING INTEREST  
RATE SWAP WITH SALOMON SMITH BARNEY**

**RECOMMENDATION:**

- 1) Adopt Resolution No.           authorizing a callable fixed-to-floating interest rate swap with Salomon Smith Barney.
- 2) Approve purchase order with Quint & Thimmig for bond counsel services not to exceed \$25,000.
- 3) Approve purchase order with Seidler-Fitzgerald for limited financial advisor services not to exceed \$25,000.
- 4) Direct staff to establish at fiscal year end a reserve account for interest hedge.

**BACKGROUND INFORMATION:**       In January 1992, the County issued \$89,905,000 Certificates of Participation (1992 Justice Center/Airport Improvements Refunding Project) (the "1992 COPs") to advance refund a portion (\$72.76 million) of the \$120,865,000 Certificates of Participation which were issued in August 1986 (the "1986 COPs"). The 1986 COPs were issued to refund the \$59,450,000 Foothill Communities Law and Justice Center Project issued in June 1983, the \$37,540,000 County Government Center Project issued in May 1983 and to fund the construction of four (4) hangers at Chino Airport.

Under the current tax code, the 1992 COPs cannot be advance refunded because they were issued to advance refund a prior tax-exempt issue. The County must wait until the first call date (July 2002) before any refinancing opportunities can be explored. Moreover, the 1992 COPs cash funded debt service reserve fund is invested in a "put agreement" which yields the County earnings of \$474,000 annually or 7.00%, which offsets debt service. If a refinancing of the 1992 COPs were possible, it would require a reduction from 5.64% to 4.44% to meet the savings target of 3% NPV.

Due to the rise in long-term interest rates during the first part of 1999, the County could not achieve savings even if a refinancing were possible. However, the County could execute a fixed-to-floating interest rate swap to reduce its current fixed 5.64% rate on the 1992 COPs to a variable rate of 4.16% (based on the most recent three-year variable rate average). This would reduce the County's borrowing cost by approximately 150 basis points and generate an average annual debt service savings in excess of \$600,000.

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Record of Action of the Board of Supervisors

A fixed-to-floating interest rate swap does not require issuance of any new COPs and therefore, does not increase the County's debt or affect the debt service reserve fund earnings. It is an execution of a swap agreement whereby the County agrees to pay Salomon Smith Barney the BMA (tax exempt variable rate) index and Salomon Smith Barney agrees to pay the County a predetermined fixed rate. The fixed swap rate the County receives reflects Salomon Smith Barney's one time right to terminate the swap in 2002 (date certain) at par and effectively offsets a portion of the fixed rate the County currently pays to its COP investors. Thus, the County's net borrowing rate becomes 4.16% based on the most recent three-year variable rate average.

Based on the historical BMA average, the swap starts on day one with a 150 basis point advantage over the current fixed rate. This means the variable rate average would have to increase over 150 basis points over the long term historical levels permanently before savings are not realized. This "break-even" point increases every day the County realizes savings.

Another way to assess the sensitivity of the variable rate exposure is to determine how much variable rates can increase each year incrementally before the County experiences dissavings. Variable rates can increase 25 basis points each and every year until the final maturity of the bonds in 2016 before the "breakeven" point is reached. Note that a 25 basis point increase every year would result in a variable rate of over 7.50% in 2016. On a net present value basis, rates would have to increase 29 basis points each and every year until 2016 to reach the "breakeven point". This would result in a variable rate of 8.23% in 2016. For comparison, the 9-year BMA average is 3.25% and the 3-year average is 3.45%.

The benefits of a swap are significant projected cash savings and protection from reduced investment earnings. Based on historical averages of the BMA Index, average annual savings range between \$600,000 and \$700,000. Total savings are projected to range from \$10.8 million to \$12.2 million based on the BMA averages. Secondly, a fixed-to-floating rate swap serves as a natural hedge against investment pool earnings. When rates are low, the investment pool earnings are reduced, but so is the County's debt service requirements. Conversely, when rates rise, investment earnings rise at the same time that debt service requirements rise. In addition, because it is a swap and not a refinance, the interest earnings on the reserve fund continues. It is staff recommendation that a one-year reserve comprised of the savings be established to act as a hedge against interest fluctuations which further protects interest earnings.

It is also staff's recommendation that the original financial advisor and bond counsel be retained. The financial advisor, Seidler-Fitzgerald, would provide services to review the structure and insure that the County receives the best interest rate given market conditions. The bond counsel, Quint & Thimmig, issued the original bond counsel opinions and is recommended to be retained to insure that the tax-exempt status is maintained.

**REVIEW BY OTHER DEPARTMENTS:** This item has been reviewed by the County Administrative Office, County Counsel, and Bond Counsel.

**FINANCIAL DATA:** This action has a projected annual savings of \$600,000 to \$700,000. In addition, it would establish a reserve fund utilizing the first year savings as an interest hedge fund.

**SUPERVISORIAL DISTRICTS:** All

**PRESENTER:** John M. Giblin, Deputy Administrative Officer